



Work Plan for Formalizing the Methodologies for the Development of Rates and New Services– Action Item

Action Item

Recommendation: Approve the DTS plan for developing the following deliverables in coordination with Department of Finance staff, for consideration by the Board at its December meeting:

- I. A formal rate development methodology that addresses both general rate setting and maintenance and temporary subsidization of services.
- II. A formal methodology for establishing new services.

The Need for Formal Methodologies

There have been several inquiries from the Board regarding rate setting methodology, particularly as it relates to new services and the process by which the Board will review and approve DTS rates. At the June 2006 meeting of the Board, the DTS Director was tasked with bringing recommendations to the Board regarding a methodology for setting rates, especially with regard to new services.

In order for the Board to effectively consider DTS proposals, its members must understand the methodologies used to develop the proposals. Further, DTS stakeholders should understand the process by which DTS rate and service proposals are reviewed and approved by the Board. Establishing formal methodologies will increase the Board's confidence that DTS proposals are developed with the expected level of consistency, transparency, and integrity.

In addition, there may be opportunities to leverage the Board oversight process for the purpose of streamlining the standard IT project and budget processes. The Board was established in part, to create transparency and increase DTS accountability to its stakeholders. The extent to which the Board governance model can be leveraged to produce efficiencies in the budget process is directly related to the integrity of its review and approval processes in the eyes of stakeholders who have budget oversight responsibilities. Thus, as the DTS methodologies and the Board's oversight role are formalized and executed in this open meeting structure, there is an important opportunity to align the information needs of the Board with those of Department of Finance and the Legislature as they relate to the review and approval of IT project and budget authority proposals from the DTS and its customers.

On the following pages, we discuss the need to establish formal methodologies with regard to rate setting and establishment of new services.



General Rate Setting and Maintenance

The Director of the Department of Technology Services is required by statute to “propose for board consideration rates for department services based on a formal rate methodology approved by the board”. Although the Board has approved a set of Guiding Principles for Cost Allocation and Rate Setting (Principles), which establish the foundation of the DTS rate setting methodology, the Principles alone are not sufficient to meet the statutory requirement (see Appendix A for full text of Principles).

Although all rates are calculated from the same basic equation ($\text{Rate} = \text{Estimated cost of Service/Estimated Volume}$), the process for estimating the cost and volume variables can vary widely by service. While this makes a detailed and universal methodology infeasible, DTS can develop a rate setting methodology that will outline the process for analyzing each variable of the rate equation at a level that can be applied universally. This should provide a clear picture of all the factors considered and how the tools available to the DTS are employed to develop its rates.

Temporary Subsidization of Services

One of the Principles adopted by the Board addresses the subsidization of new services. Specifically Principle #5 states:

“The revenues generated from the rates should fully recover the costs of the service, plus allowable reserves for working capital and equipment replacement. In order to facilitate the adoption of new services and/or the transition of customers to more efficient technologies, this principle may be suspended for a specific service for an actively managed period of transition. This exception will only be made for a documented policy objective and for a defined time period, after which the service is required to be compliant with the principle.”

The exception provided in this principle for the temporary subsidization of a rate both solves and creates issues of fairness between customers. On one hand, if rates are set exactly to cost, the rates for new services would be much higher for early adopters and fall over time as economies of scale produce a lower rate. Such a situation would create an incentive for customers to wait until rates decrease. This could prevent the service from growing at all, which would be counterproductive to the state’s goal of promoting shared services. On the other hand, subsidizing a service means revenue collected through other services is being used to fund the expenditures of the subsidized service, which raises the question of why and for how long existing customers should help pay the bill for services they are not necessarily using. Further, there have been concerns about how this exception would relate to the federal funding of programs utilizing DTS services.

In order to allow subsidization and mitigate the related concerns about fairness, the exception language in the principle includes parameters under which the exception can be made. The



Board has expressed an interest in the methodology by which rates would be developed under this exception and how progress toward the stated policy objective would be monitored over the transition period.

Establishment of New Services

As the DTS develops new services, the Board must make informed decisions about the establishment and growth of these services. To do this the Board must not only understand the methodology behind rates but also the methodology for evaluating the business value of providing the service from both a tactical and strategic perspective. From a tactical perspective, the customers each Board member represents require detailed information to determine the costs and benefits of using the new service. On a strategic level, the Board needs information regarding how the new service relates to the goals and objectives of the state's IT program on an enterprise level. A formal methodology for evaluating and communicating the business case for new service offerings will assist all stakeholders in considering the value of the service from their particular perspective.

Scope of Proposed Deliverables

DTS proposes to develop formal methodologies for rate setting, temporary subsidization of services and establishment of new services that will address:

1. What information will be included in support of DTS proposals to the Board?
2. How will DTS rate and service proposals be reviewed and approved?
3. How can the additional information provided through this process help streamline the IT project and budget processes for DTS and its customers?

In order for this effort to be successful, these questions must be answered in coordination with stakeholders, particularly those with oversight responsibility. The DTS proposes that a workgroup be formed with staff at the Department of Finance to help shape the answers to these questions in a manner satisfactory to all concerned.

This effort will result in the following specific deliverables:

I. A formal rate development methodology that addresses both general rate setting and maintenance and temporary subsidization of services.

General rate setting and maintenance methodology will:

- a. *Provide the Board with an understanding of the process by which rates are developed.*
- b. *Establish what information will be included in DTS rate proposals.*
- c. *Establish a review and approval process for DTS rate proposals, including adjustments that may be necessary between the comprehensive rate packages.*

The temporary subsidization of services methodology will:



- a. Provide the Board with an understanding of the process for determining the need for subsidization and how rates are set and monitored when subsidization is deemed necessary.*
- b. Explain how the temporary subsidization of services affects the state's ability to receive reimbursement for the federal share of DTS charges when applicable.*
- c. Establish what information will be included in DTS proposals for the approval of a subsidized rate.*
- d. Establish a review and approval process for DTS rate proposals that involve temporary subsidization.*

II. A formal methodology for establishing new services that will:

- a. Establish what information will be included in DTS service proposals to assist in evaluating them from both a tactical and strategic perspective.*
- b. Provide a business case framework that can serve as the justification for DTS and customer proposals for project and budget authority related to the establishment or expansion of the service.*
- c. Establish a review and approval process for the establishment of new services.*
- d. Provide the DTS with the maximum agility to meet customer needs and minimize time to market for new services while maintaining or improving the quality of information available to the Board, the Department of Finance and the Legislature for their respective oversight responsibilities.*



Appendix A

DEPARTMENT OF TECHNOLOGY SERVICES

GUIDING PRINCIPLES FOR COST ALLOCATION AND RATE SETTING

COST ALLOCATION

The purpose of the guiding principles is to provide the foundation for the Department's cost allocation and rate setting policies and procedures. These principles are intended to provide high-level guidance when evaluating alternate courses of action and provide the criteria against which the Department's policies and procedures for cost allocation, cost accounting, and rate development will be evaluated.

The purpose of the Department of Technology Services (Department) cost allocation methodology is to determine, as accurately as is reasonable, the actual cost of providing services to external customers in order to:

- Provide the basis for setting rates.
- Provide management with the cost data needed to effectively manage their business and service offerings.

The Department's cost allocation principles, developed in accordance with Office of Management and Budget (ONB) Circular A-87 and State Administrative Manual, Section 8752, are as follows:

- Costs should be charged directly to the project, product, process, or activity to which they are attributable to the greatest extent reasonable.
- Costs should be charged to overhead only when they are: (1) not directly chargeable without unreasonable effort; and (2) incurred for a common purpose benefiting more than one project, product, process, or activity.
- All projects, products, processes, or activities that benefit from an overhead activity will receive an appropriate allocation of overhead costs.
- One project, product, process, or activity will not support or subsidize another.
- Similar costs will be accorded consistent treatment throughout the organization.
- Costs must be "reasonable" and "allowable" to be charged to a particular project, product, process, or activity.
- Costs and their allocation methodologies must be adequately documented.

Reasonable Cost: According to OMB Circular A-87, a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under circumstances prevailing at the time the decision was made to incur the cost.

Allowable Cost: According to OMB Circular A-87, a cost allowable is it is necessary and reasonable and conforms to applicable laws and regulations.



RATE SETTING

1. The Department strives to have reasonable rates for comparable services.
2. The Department's rates must be justifiable and supportable.
3. The Department's internal systems should provide accurate and timely cost and activity data for rate setting and billing purposes.
4. Services will be periodically reviewed to determine the most appropriate rate-setting methodology according to the type of service (that is, measured usage, subscription, direct bill).
5. The revenues generated from the rates should fully recover the costs of the service, plus allowable reserves for working capital and equipment replacement. In order to facilitate the adoption of new services and/or the transition of customers to more efficient technologies, this principle may be suspended for a specific service for an actively managed period of transition. This exception will only be made for a documented policy objective and for a defined time period, after which the service is required to be compliant with the principle.
6. The effort required for rate setting should be commensurate with the benefits derived.
7. The rate setting process should provide mechanisms for ongoing rate review from a financial, technical, and business perspective.